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POSTAL REGULATORY COMMISSION

PERIODIC REPORTING (UPS PROPOSALS ONE, TWO AND THREE)	))	Docket No. RM2016-2

REPLY COMMENTS OF
AMAZON FULFILLMENT SERVICES, INC.

March 25, 2016

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REPLY COMMENTS OF
AMAZON FULFILLMENT SERVICES, INC.

Amazon Fulfillment Services, Inc. ("AFSI") respectfully submits these reply comments on Proposals One and Two of United Parcel Service, Inc. ("UPS"). These comments respond mainly to the initial comments of National Postal Policy Council ("NPPC"), the Public Representative, and Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. ("Valpak") in this docket,[1] and the comments filed by the American Consumer Institute Center for Citizen Research ("ACICCR") on February 2, 2016, which target the issues in this case although nominally filed in Docket No. ACR2015. AFSI is separately filing today a reply declaration by Professor John C. Panzar.

AFSI is the logistics and distribution subsidiary of Amazon.com, Inc. ("Amazon"). Customers who buy goods from Amazon rely on the package delivery services provided by the United States Postal Service (the "Postal Service") as a vital distribution channel. So do the customers of the independent merchants (manufacturers, wholesalers, and retailers, large and small) who sell goods on Amazon and other online commerce websites.

Amazon has become increasingly concerned about recent efforts to persuade the Commission to limit the Postal Service's ability to compete on price. The proposals under consideration in this docket should alarm consumers and e-commerce retailers throughout the United States. The proposals, advanced by a private competitor of the Postal Service,

[1] Comments of the National Postal Policy Council (Jan. 27, 2016); Public Representative Comments (Jan. 27, 2016); Valpak Direct Marketing Systems, Inc., and Valpak Dealers' Association, Inc. Initial Comments on United Parcel Service, Inc.'s Proposed Changes to Postal Service Costing Methodologies (Jan. 27, 2016).

would increase the costs attributed to Postal Service package services and other competitive products by 31 percent, or $3.4 billion a year. The costs attributed to market-dominant products such as First-Class Mail and magazines would increase by an average of 47 percent, or more than $13 billion a year. For the reasons stated in these reply comments as well as in in AFSI's January 25 initial comments, the Commission should decline to adopt Proposals One and Two.

I. INTRODUCTION

The most striking aspect of the initial comments in this case is the lack of support for Proposals One and Two by the users of market dominant mail products, the very mailers on whose behalf UPS claims to speak.[2] Nine mailer associations, individual mailers, and suppliers to mailers—American Catalog Mailers Association, Alliance of Nonprofit Mailers, Continuity Shippers Association, Envelope Manufacturers Association, Greeting Card Association, National Association of Presort Mailers, Parcel Shippers Association, PSI Systems, Inc., and Stamps.com (collectively "Market Dominant Mailers")—oppose both proposals outright.[3] The other two commenters that represent market dominant mailers—NPPC and Valpak—take no position on whether Proposals One and Two should be adopted, and focus their comments mainly on rate design issues within market dominant mail itself.

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[2] *See*, *e.g.*, UPS Petition for Rulemaking (Oct. 8, 2015) at 2-6, 9, 14, 17 (asserting that UPS is acting to prevent the "hidden subsidization of competitive products by captive mail customers").

[3] Comments of American Catalog Mailers Association, Inc., et al. ("Market Dominant Mailers") (Jan. 27, 2016); Initial Comments of the American Catalog Mailers Association ("ACMA"); Comments of the Parcel Shippers Association ("PSA") (Jan. 25, 2017).

The lack of enthusiasm for Proposals One and Two by their purported beneficiaries is unsurprising. In the guise of ratepayer protection, Proposals One and Two would suppress price competition saddling the Postal Service with arbitrarily inflated price floors. Adoption of Proposals One and Two would harm parcel shippers and their customers (because their shipping costs would likely increase substantially), other mailers and their customers (because the same methodologies would likely increase prices for some market dominant products and damage the Postal Service's financial health), and the Postal Service itself (because arbitrarily inflated price floors would cause the Postal Service to lose profitable business). The only beneficiaries would be competitors of the Postal Service.

There is no principled economic justification for these anticompetitive results. As AFSI, a wide range of other mailers and package shippers, and the Postal Service showed in their initial comments, the measures of attributable and incremental cost now used by the Commission as tools of minimum price regulation satisfy 39 U.S.C. §§ 3631(b), 3633(a)(1), and 3633(a)(2). The record contains no evidence that domestic competitive products fail to cover incremental costs; to the contrary, these products make a large and growing contribution to the Postal Service's institutional costs. There is likewise no evidence that the Postal Service's pricing of its competitive products amounts to unfair competition.

In any event, adoption of Proposal One or Two would be unlawful because each proposal would attribute costs to individual mail products without reliable evidence of causation. Proposal One is unlawful because, when marginal costs decline with increasing output, the only inframarginal costs that can be causally attributed to individual products are the incremental costs of individual products. Variable costs that are caused jointly by two or more products are not caused by any individual product. Moreover, even if the attribution of all inframarginal costs were correct in theory, Proposal One would still be unlawful because no reliable method of calculating inframarginal costs now exists.

Proposal Two also violates the statutory causation requirement for cost attribution. The proposal would reclassify as variable $3.4 billion of costs now reported as fixed. The regression analysis underlying this proposal is hopelessly flawed. Moreover, if the analysis were applied to all postal costs, it would indicate that the Commission's current methods understate, not overstate, the extent to which total Postal Service costs are fixed.

The only commenters to offer more than a token defense of either of the Proposals are the Public Representative and the ACICCR. None of their arguments withstand scrutiny. For the reasons explained below and in the initial comments of AFSI, the Postal Service, and other mailers and package shippers, both Proposals One and Two are economically unsound and unlawful. The Commission should reject both.

II. THE COST STANDARDS USED BY THE COMMISSION TO SET PRICE FLOORS FOR COMPETITIVE PRODUCTS ARE CONSISTENT WITH SOUND ECONOMIC PRINCIPLES AND THE LAW.

A. Economically sound price floors for each increment of volume must be limited to the costs that are *caused by* that increment of volume.

As AFSI explained in its initial comments, economically sound price floors for each increment of volume must be limited to the costs that are *caused* by that increment of volume, in the sense that eliminating the volume would also eliminate the costs. Inflating price floors by requiring that individual products or other increments of volume cover allocations of costs not caused individually by those increments of volume would harm consumers, parcel shippers, other mailers, and the Postal Service itself. The only beneficiaries would be the Postal Service's competitors. AFSI at 7-9, 26-38, and Panzar Decl. at 2-7, 10-31; *accord*, Bradley (USPS) Decl. 2-14; Market Dominant Mailer comments at 3-5; PSA at 6-7.

Even the Public Representative, the only sponsor of initial comments in the present rulemaking that even partially supports Proposal One, admits that this could occur:

> UPS's push for additional attributable costs can represent an understandable attempt in its corporate interest to force the Postal Service, under the umbrella of regulatory law, to raise its competitive product prices higher than it would raise them otherwise, but that may impact the marketplace in a way that may be viewed as contrary to the public interest.

Public Representative at 44. *Accord*, *id*. at 46 (a "forced increase in the Postal Service's estimated attributable costs would set a higher price floor that could prevent the Postal Service from adjusting competitive product prices downward below that floor if necessary to meet competitors' prices. That may tilt the field in the direction away from free and open competition. That may not be in the public interest.").

As evidence of the seriousness of this competitive risk, the Public Representative concedes that, in the vast majority of domestic competitive rate and service agreements approved by the Commission in recent years, the Commission credited the Postal Service's allegation that the agreed-upon discounts from generally available rates were required by intense competition from private carriers. *Id*. at 44-45. "Thus, each of these cases stands testament to the fact that substantially raising the current NSA offering prices by substantially raising attributable costs of competitive products would risk the loss of a significant level of business in a highly competitive market. That loss could be contrary to the Postal Service's interest and the public interest in a vital and efficient universal mail system." *Id*. at 45.

The same is true of Priority Mail. The Public Representative acknowledges that, "[f]or Priority Mail, where many of the Postal Service's rates are already considerably higher than their competitors, it makes little sense to order a change in costing methodology that will clearly increase attributable costs that can force further price increase on the Postal Service where it now only enjoys a 15 percent market share. This can only tilt market share further towards Postal Service competitors." *Id*. at 50.

These are serious concerns indeed, especially because the Postal Service's package-delivery business has been the Postal Service's only source of significant earnings growth in recent years as the mail delivery business has contracted. *See*, *e.g.*, Postal Regulatory Commission, *Financial Analysis of United States Postal Service Financial Results and 10-K Statement: Fiscal Year 2015* (April 1, 2015) at 30 (showing long-term downward trend for market dominant mail); *id*. at 41 (showing growing contribution of competitive products).

B. The Commission's marginal, attributable and incremental cost standards satisfy 39 U.S.C. §§ 3631(b), 3633(a)(1) and 3633(a)(2).

In its initial comments, AFSI showed that the measures of attributable and incremental costs adopted by the Commission as price floors satisfy the requirements of 39 U.S.C. §§ 3631(b), 3633(a)(1) and 3633(a)(2) and the judicial and Commission precedent construing those provisions. Those cost measures include all costs that have a reliably identified causal relationship with the increment of volume at issue, but exclude allocations of costs that lack such a relationship. AFSI at 22-26, 38-64; *accord*, Market Dominant Mailers at 5-7; USPS at 5-9. Although a few commenters claim that infra-marginal costs may also have a sufficient causal relationship to be attributed to individual classes and products—a claim that is unfounded for the reasons discussed at pp. 20-24, below—no commenter disputes the cost causation requirement itself.

C. The record contains no evidence that the attributable and incremental cost data relied on by the Commission significantly understate the marginal and incremental costs of competitive products.

AFSI also showed in its initial comments that the record contains no evidence that the estimates of attributable and incremental costs developed by the Postal Service and approved by the Commission in recent years materially understate the Postal Service's true marginal and incremental costs, let alone understate those costs enough to overcome the evidence that competitive products are making a large and growing net contribution to the Postal Service's institutional costs. AFSI at 64-69; *accord*, Market Dominant Mailers at 8-9. No commenter disputes this.[4]

D. ACICCR offers no evidence that the Postal Service's pricing of its competitive products represents unfair competition.

As AFSI also showed in its initial comments, the record refutes UPS's claim that the Postal Service is competing unfairly with private carriers. The only commenter to assert to the contrary is ACICCR. ACICCR's position is unsupported.

[4] Valpak, whose comments deal mainly with the pricing of *market dominant* products such as Standard Mail flats, urges the Commission to replace the attributable cost floor on the prices of market dominant products with an incremental cost floor. Valpak at 4-18. These issues are beyond the scope of this proceeding. We note only that (1) the Commission has given considerable attention to this issue in past cases, and (2) the difference between incremental and attributable (or volume variable) costs is small except when the increment of volume is a large majority of total Postal Service volume. AFSI at 50-53, 57-67.

First, the average effect of the 2014 changes in Priority Mail rates, the main focus of UPS's claim, was *zero*. Second, over the time span since 2007, the overall growth in prices charged by the Postal Service for its competitive products has greatly outstripped inflation. Third, the Postal Service's overall share of total volume of package and express delivery service is relatively small. Finally—and most important—whether the Postal Service is discounting aggressively and thereby capturing significant volume from private competitors is ultimately irrelevant. Even aggressive discounting to gain volume does not constitute unfair competition if the discounted rates cover the marginal cost of individual services, and the rates for larger increments of competitive volume cover their average incremental costs. AFSI at 69-74; *accord*, PSA at 2-6; USPS at 35-45.

The initial comments of the Public Representative are to similar effect. They observe that the Postal Service appears to face intense competition in most domestic product market segments now classified as competitive (Public Representative at 44-45); UPS and FedEx services have lower prices and a perceived higher quality of service than many of the corresponding Postal Service products (*id*. at 45-48); despite the rate reductions in Fiscal Year 2014 on Priority Mail, the Postal Service's rates "in many cells are back above their competitors' rates" and "differ by a few pennies" in most other cells (*id*. at 48-49); and Priority Mail rates are continuing to increase faster than the prices charged by UPS and FedEx for their competing services (*id*. at 49-50). The Public Representative also observes that "UPS Ground and FedEx Ground together dominate the share of revenue derived from the market that includes Postal Service Priority Mail" (*id*. at 51); both private companies are far more profitable than the Postal Service (*id*. at 51-52); and both companies "also have access to production volumes affording them economies of production" from market segments in which the Postal Service does not compete or has only a small presence (*id*. at 49-50).

The only commenter to support the theory of unfair competition is ACICCR. In comments filed in Docket No. ACR2015 on February 2, 2016, ACICCR asserts that the Postal Service's failure to allocate "fixed and institutional costs" between market dominant and competitive services in proportion to their attributable costs is a "misallocation of cost recovery" that "enables the agency to use its monopoly power to prop up unregulated products and services" by "shifting dollars from profitable regulated services to unprofitable or less profitable unregulated venture." ACICCR at 2-4. ACICCR offers a "simple" "solution": the Postal Service should be required to set all of its prices at fully allocated costs. *Id*. at 4-5. The premise of ACICCR's cross-subsidy theory, however, is that postal products are cross-subsidized whenever their rates are less than fully allocated costs. As AFSI showed in its initial comments, this theory has been discredited for decades.

(1)

Fully allocated cost is not a valid test for cross-subsidy. Although many regulators used the cost measure as a maximum rate ceiling, minimum rate floor, or test for cross-subsidy during the first two-thirds of the 20th century, economists since then have overwhelmingly rejected the use of fully allocated costs for any of these purposes. In particular, economists now believe that rates are cross-subsidized only if they fail to cover marginal and incremental costs. AFSI at 10-11, 26-38 (citing economic literature); Panzar Decl. at 2-3, 13-15, 20-31; USPS at 22 and Bradley Decl. 10-13. Fully allocated cost price floors have also been rejected by a growing consensus of legislators, regulators and courts—including, in the postal context, the Commission, Congress, and the Supreme Court. AFSI at 8, 10-12, 38-64, 73-74; USPS at 5-13. ACICCR makes no mention of the overwhelming economic and legal authority against its approach.

ACICCR tries to brush off the Commission's test for cross-subsidy—coverage of incremental costs—on the theory that this is an adequate test for cross-subsidy only in the short run, and that in the long run all "ventures" must cover "their" fully allocated costs. ACICCR at 3-4. ACICCR confuses the collective output of a firm with its individual products. To be sure, a firm must cover all of its costs to stay in business over the long run. But when a firm offers multiple products, and some of the costs of producing those products are incurred jointly or in common by multiple products, any individual product can make the firm better off financially if the revenue from the product exceeds its incremental costs. The firm will survive—indeed, thrive—over the long run as long as its prices *in the aggregate* cover the firm's total costs. This is an inherent structural characteristic of firms with joint and common costs. AFSI at 28-29 n. 8 and Panzar Decl. 12-13; *accord*, USPS at 24; *see generally* AFSI at 28-38 (citing literature). These principles are hardly novel; economists have recognized them since the 1840s.[5]

(2)

Nor is it unfair competition for the Postal Service to take advantage of the economies of scale and scope created by the size and reach of its delivery network. The Commission's

[5] *See* Arthur Hadley, *Railroad Transportation* 76-77, 111-24, 261-65 (1886); Taussig, "A Contribution to the Theory of Railway Rates," 5 *Quart. J. of Econ.* 438 (1891); Watkins, "The Theory of Differential Rates," 30 *Quart. J. of Econ.* 682 (1916); Locklin, "The Literature on Railway Rate Theory," 47 *Quart. J. of Econ.* 167 (1933) (summarizing early literature).

role is to protect competition, not competitors. AFSI Comments at 73-74 (citing precedent). Competition and consumers are benefitted, not harmed, when the Postal Service shares its economies of scale and scope with its customers through lower prices. *See id*. at 83 (citing 1 Kahn, *The Economics of Regulation* 172-73 n. 25) (arguing that integrated gas and electric companies should be allowed to use their economies of scale and scope in competing with "unregulated heating oil distributors," if necessary by pricing down to marginal cost); *accord*, Panzar Decl. at 14; USPS at 24-25.[6]

(3)

ACICCR also fails to offer any coherent explanation for how the alleged cross-subsidy might occur even if—contrary to the Commission's consistent findings in its Annual Compliance Determination Reports that domestic competitive products make a sizeable contribution to the Postal Service's institutional costs—the Postal Service were losing money on those products. The standard model for cross-subsidy between two groups of services offered by a multi-output regulated firm assumes that losses sustained on the subsidized services will increase the revenue that the firm is allowed to collect from users of the subsidizing services. But the Postal Accountability and Enhancement Act of 2006 ("PAEA"), by replacing cost-of-service ratemaking with index-based ratemaking for market-dominant

[6] In any event, any analysis of the competitive advantages conferred by economies of scale and scope must also consider the economies of scale and scope that UPS and FedEx enjoy from lines of business in which the Postal Service's share is much smaller (international service) or nonexistent (parcels weighing more than 70 pounds, heavy freight, supply chain management, international trade consulting, corporate financing, billing and collection services, and document services). *See* USPS Form 10-K for 2015 at 4, 8-9; FedEx Form 10-K for FY 2015 at 3, 9-10; Public Representative at 49. The Postal Service not only does not offer these related products, but is barred by 39 U.S.C. § 404(e) from offering them.

products, severed this link. Failing to maximize the profitability of competitive products—or even incurring outright losses on those products—would not increase the rates that the Postal Service could charge for its market dominant products at all.[7]

(4)

There is also no basis for finding that the Postal Service's prices for competitive products are subsidized by the legal preferences that the Postal Service receives under federal and state law. To determine whether such a subsidy exists, one must consider the net economic effect of both the benefits and burdens to the Postal Service, not just the benefits. The 2007 report of the Federal Trade Commission ("FTC") under Section 703(a) of the PAEA did just that. Section 703(a) directed the FTC to prepare a "comprehensive report" identifying the "federal and State laws that apply differently to the United States Postal Service with respect to the competitive category of mail and to private companies providing similar products." *Id*. (codified at 39 U.S.C. § 3633 (note following)). The FTC found that the Postal Service's status as a federal government entity provided an implicit subsidy to its competitive products operations in the range of $39-$117 million per year, and federally-imposed legal restraints on the Postal Service's operations increased its costs of providing competitive products by an estimated $330-$782 million per year. FTC, *Accounting for Laws*

[7] The exigency provision of 39 U.S.C. § 3622(d)(1)(E) does not change this fact. The provision allows recovery of losses by imposing above-CPI rate increases on market dominant products only if the losses result from "extraordinary or exceptional circumstances," and only if the above-CPI increases are "reasonable and equitable and necessary" to enable the Postal Service to provide services needed by the United States under "best practices of honest, efficient, and economical management." Losses incurred through deliberate or even negligent underpricing of competitive products would fail each of the quoted requirements.

that Apply Differently to the United States Postal Service and Its Private Competitors (Dec. 2007) at 8; *see also* USPS at 45-46 (discussing FTC report).

Compared to the effects of UPS Proposals One and Two, these are small amounts. The estimated subsidy equaled only 0.6 to 1.8 percent of competitive product revenue at the time; the estimated burdens equaled only 3 to 8 percent of competitive product revenue. *Id*. And both sets of figures are only a small fraction of the $3.4 billion in additional costs that Proposals One and Two would shift to competitive products. *See* Market Dominant Mailers at 4-5 & Attachment I.

Moreover, as the Public Representative notes, several developments since 2007 probably have *reduced* the risk that the benefits and burdens to the Postal Service from federal law could disadvantage efficient private competitors. These developments include the transfer of several market dominant products to the competitive product list, the substantial rise in the average prices charged by the Postal Service for its competitive products since 2007, and the steadily growing profitability of the major private competitors. Public Representative at 7 (the competitive playing field "has been further leveled as prices for the Postal Service competitive parcel products, overall, have risen substantially in recent years, in part by the transfer of several market dominant categories of parcels to the competitive product list"); *id.* at 16-18.[8]

[8] Two related points by the Public Representative warrant a response, however. First, the Public Representative suggests that Section 703(d) of PAEA may require the Commission to defer a decision on Proposals One and Two until the Commission has "take[n] into account events that affect the continuing validity of the FTC's estimate of the net economic effect of federal laws with respect to the competitive category of mail." Public Representative comments at 2-3, 15-16, 33, 53. Section 703(d), however, requires, consideration of these events only if the Commission chooses to *revise* its regulations under 39 U.S.C. § 3633. *See*

(5)

ACICCR's theory of unfair competition founders on another ground: private carriers have not performed like victims of unfair competition. The private carriers are profitable, growing, and investing heavily in expanding their capacity and improving their technology.

The press release issued by UPS on February 2, 2016, to announce its fourth quarter 2015 results is illustrative. The document, entitled "UPS Delivers Peak Profits," announced that the company's adjusted diluted earnings per share increased by 14 percent of 2014 adjusted results, with "all three business divisions" enjoying "expanded operating margins" and "double-digit operating profit growth."[9] UPS attributed its "great service and record financial performance" to the company's "flexible integrated network, close collaboration with customers and the extraordinary efforts of UPSers." *Id*. "This year's results built on our multi-year strategy to deliver improved shareholder value." With particular respect to UPS's U.S. domestic package division, the report added:

PAEA § 703(d) (codified as note following 39 U.S.C. § 3633). Rejection of Proposals One and Two would not entail any change in the regulations. In any event, consideration of the post-2007 developments discussed in the main text above merely confirms the lack of merit in Proposals One and Two.

Second, the Public Representative asserts that "[t]here can be no doubt that the playing field was intended to be tilted toward a more level playing field for Postal Service competitors by passage of the provisions in the PAEA." Public Representative at 7. Nothing in the text or legislative history of the PAEA stated (or implied) that playing field was initially tilted toward the Postal Service. *See* AFSI Comments at 53-56 (discussing text and legislative history of PAEA); USPS at 6-7.

[9] "UPS DELIVERS PEAK PROFITS," UPS News Release issued Feb. 2, 2016 (downloaded on March 14, 2016 from http://phx.corporate-ir.net/phoenix.zhtml?c=62900&p=irol-EventDetails&EventId=5213153).

> Strong demand from ecommerce shippers contributed to a 2.4% increase in average daily shipments. Deferred Air products soared 15% and Next Day Air was up 10% over the same period last year. UPS completed deliveries to more than 1.9 million new addresses during December, demonstrating the growing influence of online retail.
>
> Adjusted operating profit increase $209 million, or more than 18% over the fourth-quarter 2014 adjusted results. Operating margin expanded 170 basis points, to 13.1% on an adjusted basis. The company's focus on revenue quality, combined with better network performance, resulted in improved operating leverage this quarter.

Id.[10]

UPS has also made clear that it is committed to investing in new technology and expanding its business. The company's Form 10-K for 2015 stated that "we have invested over $1 billion in facility expansions and equipment modernization since 2014" to "meet the significant growth in package delivery volume" generated by "[g]rowth in U.S. online sales, which are estimated to nearly double by 2020." UPS Form 10-K for 2015 at 6.

FedEx's reports to investors and the Securities Exchange Commission are in the same vein. The company's annual report to shareholders for Fiscal Year 2015 emphasized FedEx's "record adjusted earnings," "higher volumes and improved base yields from each transportation segment," and "industry-leading automation." FedEx Annual Report 2015

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[10] In an investor relations presentation two weeks later, UPS described its "industry-leading" return on invested capital, the "industry leading margins" of its small package business, the $5 billion in free cash flow that the company generated in 2015, the 45-year history of growth in its shareholder dividends, with a compound annual growth rate averaging 9.9 percent. UPS Investor Overview 8-13 (Feb. 17, 2016) (downloaded March 14, 2016 from http://www.investors.ups.com/phoenix.zhtml?c=62900&p=irol-investorpres). UPS also forecasted that "online retail" would be UPS's "growth engine for [the] future." *Id.* at 16.

at 1-2. With specific respect to the company's Express and Ground division, the company stated:

> FedEx Express is successfully lowering costs and increasing base yields through the profit improvement program. FedEx Express has made structural changes to reduce costs and is retiring older aircraft while adding new Boeing 767s to rationalize capacity and modernize our aircraft fleet. We are serving customers with more efficiency for their less-time-sensitive shipments.
>
> FedEx Ground continues to pull ahead of competitors. Margins at FedEx Ground remain strong, and we continue to improve service. FedEx Ground is faster to more U.S. locations than the competition. As e-commerce continues to reshape the transportation business, FedEx Ground invested $1.2 billion in FY 15 in facilities and automation to support future growth.

Id. at 4. For Fiscal Year 2016, FedEx projected "1.6 billion in annual profit improvements" for FedEx Express, and gains in volume "with industry-leading margins" for FedEx Ground. FedEx investor roadshow presentation (Jan. 11, 2016) (downloaded March 14, 2016 from http://s1.q4cdn.com/714383399/files/doc_presentations/2016/Roadshow-January-11-2016-f.pdf).

The company's March 16, 2016 earnings report for the quarter ended February 29, 2016, was equally upbeat. Adjusted earnings for the quarter were up 23.6 percent over the same quarter in the previous year.[11] While earnings of the company's Ground segment were slightly down over the same quarter in 2015 because of higher costs, revenue was up 30 percent.[12] For the company's Express segment, operating income was up 51 percent over the

[11] FedEx news release, "FedEx Corp. Reports Strong Adjusted Third Quarter Earnings" (March 16, 2016) at 1 (downloaded March 18, 2016 from http://s1.q4cdn.com/714383399/files/doc_news/earnings/2015/FedEx-Q3-FY16-Earnings-Release.pdf).

[12] *Id.* at 3.

same quarter in fiscal year 2015.[13] The company also projected that earnings for the full fiscal year would be up 20-22 percent over the previous year, and that the "solid growth in earnings and cash flow" would continue in fiscal year 2017.[14] In a conference call with securities analysts to discuss the earnings report, FedEx CEO Fred Smith added that the company "is currently investing in FedEx Express fleet modernization and expansion of FedEx Ground's highly automated facilities. Both of these major programs have high returns . . . In fact, if we were to isolate our e-commerce business one could argue that FedEx is one of the most profitable e-commerce companies in business today."[15]

What is true for UPS and FedEx also appears true for the private delivery industry as a whole. Many regional parcel carriers have experienced "double-digit volume growth" and "network expansion" since 2014.[16]

Finally, competitors of the Postal Service have been able to impose above-inflation increases in their retail prices since 2006. Between December 2006 and December 2015, the Bureau of Labor Statistics price index for delivery services ("CPI—Delivery Services"), which measures changes in the retail prices charged to household consumers by FedEx, UPS and

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[13] *Id*. at 2.

[14] *Id*. at 2.

[15] Transcript of FedEx earnings conference call (March 16, 2016) (statement of FedEx CEO Fred Smith) (downloaded Mar. 18, 2016 from http://seekingalpha.com/article/3959098-fedexs-fdx-ceo-fred-smith-q3-2016-results-earnings-call-transcript).

[16] Rob Martinez, "Regional Parcel Carriers Industry Updates for 2015: Volume Growth, Geographic Expansion & Industry Consolidation" (www.broussardlogistics.com/regional-parcel-carriers-industry-updates-2015-volume-growth-geographic-expansion-industry-consolidation-whats-new-regional-parcel-carries-2015/).

other private (non-Postal Service) carriers for delivery of letters and packages, rose by more than 64 percent, for a compounded average annual growth rate of 5.64 percent—far in excess of the overall increase in the CPI during the same period.[17] An industry oppressed by unfair competition would not be able to sustain above-inflation price increases of this magnitude and duration.

In sum, UPS, FedEx and many of the smaller private carriers are successful and well-managed companies that have good reason to be pleased with their performance. AFSI uses many of those companies, including UPS and FedEx, and considers them to be valued business partners. But their growth and profitability refute any claim that the Postal Service's pricing of its competitive products is preventing its private competitors from competing effectively.

(6)

The views of mailers who actually rely on market dominant mail provide another reality check on the ACICCR's claims. The comments of the Market Dominant Mailers oppose both proposals. NPPC and Valpak are neutral about both. *See* NPPC at 3 (stating that NPPC "takes no position on the merits of UPS's suggestion that Shapley Values be used to distribute [inframarginal] costs" or the "specific recommendations that UPS is urging the Commission to adopt in Proposal Two"); Valpak at 21 (stating that Valpak "takes no position" on Proposal One "at this early stage of this docket"; *id*. at 2 (stating that Valpak is

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[17] To obtain the CPI-Delivery Series data series from the Bureau of Labor Statistics website, query the BLS website search engine (http://data.bls.gov/pdq/querytool.jsp?survey=cu) with "Delivery Services" as the search term.

not addressing Proposal Two in its initial comments). These commenters are sophisticated entities with a genuine economic stake in the prices charged for every major product of market dominant mail. The judgments of these commenters about their own economic interests are far more credible than the claims made on their supposed behalf by UPS and ACICCR.

III. PROPOSALS ONE AND TWO ARE UNSUPPORTED BY RELIABLE EVIDENCE OF CAUSATION AND ARE THEREFORE UNLAWFUL.

A. Proposal One

In its initial comments, AFSI explained that UPS Proposal One would violate 39 U.S.C. §§ 3622(c)(2), 3631(b) and 3633(a)(1) and (2) by attributing costs to individual classes and products that do not cause those costs. AFSI comments at 75-85, and Panzar Decl. at 2-4, 15-29; *accord*, Market Dominant Mailers at 9-13; USPS at 5-9, 13-16, and Bradley Decl. at 22-38. The initial comments of NPPC, Valpak and the Public Representative offer no cogent argument to the contrary.

(1)

NPPC, while taking no position on whether Proposal One should be adopted, asserts that "inframarginal costs are a part of a product's incremental costs and should be included when testing for cross-subsidy." NPPC at 3, 6-7 & nn. 11-12. According to NPPC, all of the rival cost attribution methods under consideration "distribute" costs to individual products and classes. Hence, NPPC reasons, the choice of "distribution" method thus boils down to "what ordering assumption is made," a question that NPPC asserts has no single correct answer—at least not one on which NPPC has an opinion. *Id*. at 6-7.

NPPC is mistaken in two important ways. First, although a portion of component inframarginal costs should be included in the incremental costs of individual products, a large share should not be. Most inframarginal costs, although varying with volume, are caused jointly in the production of two or more products, and cannot be causally attributed to any individual product. Professor Panzar demonstrates this mathematically and graphically in his reply declaration, and explains why Proposal One would inappropriately attribute costs in excess of incremental costs to individual products. Panzar Reply Decl. 2-13; *accord*, Panzar Decl. 2-4, 10-13, 15-31; Bradley (USPS) Decl. at 28-35.

Second, economics provides a definite answer to the choice of ordering assumptions. Ordering assumptions matter whenever marginal costs decline as volume increases (the condition that gives rise to inframarginal costs). When this condition holds, a fundamental attribute of marginal, attributable and incremental costs requires that they must *always* be determined by assuming that *every* increment of output being costed is produced last (or avoided first). This assumption is what makes marginal cost marginal, and incremental costs incremental: they are literally at the margin (or last increment) of output. Jettisoning this assumption takes us out of the realm of causation-based costing, and into the world of non-economic cost allocation. This is not an advanced concept: it is a fundamental tenet of microeconomics. AFSI Comments at 90, and Panzar Decl. 19; Panzar report to PRC (2014) at 6; Market Dominant Mailers at 10-11; USPS at 18, 20-22, and Bradley Decl. at 6-13, 28-31.

(2)

Valpak, which also takes no position on Proposal One, nonetheless asserts that the "cost methodology incorporated in UPS Proposal One also appears to meet the economic standard for causality." Valpak at 20. Valpak's basis for this offhand statement is unclear; in any event, it is incorrect for the reasons previously stated.

(3)

The Public Representative's assertion that UPS has made the necessary showing of a reliable causal link between "inframarginal costs and competitive products" (Public Representative at 3, 21, 25-32) is mistaken for essentially the same reasons as NPPC's similar claim. To be sure, *some* inframarginal costs are properly included in the *incremental* costs of an individual product because they would be avoided if the product were no longer produced. But inframarginal costs that would not be avoided if a product were eliminated because the costs are caused jointly by *multiple* products, properly belong to neither the marginal nor the incremental costs of that product. They are joint or common costs, and must be recovered through means other than minimum price floors. Panzar Reply Decl. at 16-17; Panzar Decl. at 12-29; Bradley Decl. at 8-13, 28-31.

The Public Representative gains nothing by analogizing the attribution of component costs to individual products with the allocation of institutional costs to individual products. While the arithmetic of the two procedures bears a superficial similarity, there is a world of difference in the underlying economic logic. Component costs are properly distributed to individual products because the costs are determined or estimated to vary with the level of cost driver activity caused by each product. Panzar Decl. 16; Panzar Reply Decl. 7-8, 15-17;

Bradley Decl. 15-22. By contrast, allocating *all* component variable costs, including inframarginal costs, to *individual* products in proportion to the level of *average* cost realized by the cost component *as a whole*—regardless of whether all of the inframarginal costs so allocated are actually caused by changes in the volume of each product—has no economic basis. Panzar Decl. 15-17; Panzar Reply Decl. 7-10, 15-17; Market Dominant Mailers at 12-13 & nn. 6-7; USPS at 26.

The Public Representative likewise gains nothing by analogizing the UPS proposal to the Commission's policy of attributing single subclass access costs as part of city carrier costs. Public Representative at 13. The Commission adopted its attribution policy for single subclass access costs out of a belief that "single subclass access costs fit the economic definition of incremental costs for the entire access cost function . . . They can be viewed as all of the access costs that would be avoided if a particular subclass of service were eliminated from the postal system." R94-1 PRC Op. and Further Rec. Decis. (June 7, 1995) at 16. The Commission's position on this issue is consistent with that of AFSI, not the Public Representative.

(4)

AFSI also showed in its initial comments that Proposal One would violate 39 U.S.C. §§ 3622(c)(2) and 3631(b) because no reliable method of calculating inframarginal costs now exists. AFSI at 85-89, and Thompson Decl. at 26-30; *accord*, USPS at 16-17 and Bradley Decl. at 36-38. The Public Representative's claim that UPS witness Dr. Neels used "the Commission's accepted methodology for calculating and distributing inframarginal costs to competitive products" (Public Representative at 25) is flatly untrue. There is no accepted methodology for estimating component inframarginal costs. Dr. Neels simply adopted a set of assumptions used in 2014 by a Commission consultant, Charles McBride. Mr. McBride in turn simply assumed that the cost defined by the volume variability assumptions used by the Postal Service in R2006-1 held true all the way to their intercept points on the vertical axis (*i.e.*, where volume was zero). But this assumption is untested—and untestable—guesswork. Mr. McBride himself expressed doubts about the reliability of this approach. AFSI Comments at 85-89; Thompson Decl. ¶¶ 61-72; Panzar Decl. at 6 n. 7; Bradley Decl. at 37-38.

B. Proposal Two

AFSI showed in its initial comments that Dr. Neels' regression analysis revealed nothing useful about the variability of postal costs. If anything, his method, when applied to both "reported fixed" and attributable costs, suggests that variability is overstated. AFSI Comments at 105-114 and Thompson Decl.; Market Dominant Mailers at 13-14; USPS at 2-4, 27-34, and Bradley Decl. at 39-61. No other commenter has endorsed Proposal Two. Even the Public Representative urges the Commission to reject Proposal Two for lack of an adequate showing of a reliable causal relationship. Public Representative at 3, 36-43. The Public Representative merely proposes that the Commission encourage further study of the issues raised by Proposal Two. AFSI agrees that further study of the variability of individual cost components would be a more useful exercise than further consideration of Dr. Neels' nonsensical regression studies. Any further analysis of variability, however, should be done in an even-handed way that allows for the possibility that existing variabilities may be overstated as well as understated.

CONCLUSION

For the reasons stated above and in AFSI's January 25 initial comments, the Commission should decline to adopt Proposals One and Two.

Respectfully submitted,

/s/

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